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No. 95-984

Supreme Court, U.S.
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IN THE
# Supreme Court of the United States
OCTOBER TERM, 1995

STATE FARM MUTUAL AUTOMOBILE INSURANCE COMPANY,
*Petitioner,*
v.
STATE OF NEW JERSEY, COMMISSIONER OF INSURANCE, *et al.*,
*Respondents.*

**On Petition for a Writ of Certiorari to the Superior Court of New Jersey, Appellate Division**

## REPLY BRIEF FOR PETITIONER

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## REPLY BRIEF FOR PETITIONER

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1. We explained in our petition for certiorari [1] that (1) this Court's decisions over the past 50 years had established that rate regulation goes too far and becomes a taking of the regulated firm's property when the firm is denied an opportunity to recover its reasonable cost of capital in the rates it is permitted to charge, (2) the court below explicitly departed from this cost of capital standard in assessing State Farm's takings claim, (3) this departure created a conflict not only with this Court's leading rate regulation cases but with numerous federal circuit and state supreme court decisions, and (4) there was no support whatever for the novel nationwide industry average standard the court below adopted in place of the discarded cost of capital standard.

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[1] Petitioner's Rule 29.6 statement appears at Pet. ii.

Respondents in their opposition to certiorari do not dispute that the court below jettisoned the cost of capital standard. Nor could they—the court expressly declared it a "misconception[]" to suppose that the cost of capital "is the minimally acceptable rate of return." Pet. App. 24a. Respondents say that this created no conflict, but they do not even cite—let alone attempt to distinguish—the numerous federal circuit and state supreme court cases holding in unambiguous terms that a constitutionally adequate rate of return "must" cover the cost of capital,[2] that investors are "entitled" to a return sufficient to cover the cost of capital,[3] and that investors have a "constitutional

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[2] *E.g., Tennessee Gas Pipeline Co.* v. *FERC*, 926 F.2d 1206, 1208 (D.C. Cir. 1991) ("utility investors must be allowed an opportunity to earn returns sufficient to 'attract capital' * * * and 'to compensate [the] investors for the risks assumed' ") (quoting *Federal Power Comm'n* v. *Hope Natural Gas Co.*, 320 U.S. 591, 605 (1944)); *AT&T* v. *FCC*, 836 F.2d 1386, 1389-90 (D.C. Cir. 1988) ("The rate of return * * * must be sufficient to cover the cost of capital the carrier must raise to do business"); *United States* v. *FCC*, 707 F.2d 610, 612 (D.C. Cir. 1983) ("The return to the equity owner must be 'sufficient to assure confidence in the financial integrity of the enterprise * * * in order that its credit may be maintained and capital may continue to be attracted.' ") (quoting *Hope*, 320 U.S. at 603); *Appeal of Cheshire Bridge Corp.*, 126 N.H. 425, 493 A.2d 1151, 1156 (1985) ("the return must equal the cost of capital"); *Attorney General* v. *Department of Pub. Utils.*, 392 Mass. 262, 467 N.E.2d 72, 75 (1984) ("In general, the return on equity must equal at least the amount which the company would have to pay in order to 'hire' its equity capital under current conditions") (citation omitted); *Hastings* v. *Village of Stowe*, 125 Vt. 227, 214 A.2d 56, 61 (1965) ("the rate of return must be sufficient to provide enough revenue for capital costs of the business, including service on the debt and dividends on the stock").

[3] *E.g., United States* v. *FCC*, 707 F.2d at 612 ("Regulated utilities are entitled to earn enough revenue not only to cover operating expenses but also to pay for the capital costs of doing business"); *Public Serv. Co. of New Hampshire*, 130 N.H. 748, 547 A.2d 269, 270-271 (1988) ("a utility's threshold entitlement is to a rate of return equal to the cost of capital").

right" to such a rate of return.[4] And respondents at no point even attempt to defend the new constitutional standard—nationwide industry average return—embraced by the court below.

Respondents' argument is instead that the cost of capital is in fact *not* the appropriate measure of a constitutionally adequate rate of return. Opp. at 8, 10. The central legal issue is thus fairly joined. We—along with the numerous courts just cited, and others cited in our petition—read this Court's decisions from *Federal Power Comm'n* v. *Hope Natural Gas Co.*, 320 U.S. 591 (1944) through *Duquesne Light Co.* v. *Barasch*, 488 U.S. 299 (1989) to establish that, in Justice Souter's words, "[a]t a minimum, the return must equal the cost of capital." *Appeal of Cheshire Bridge Corp.*, 493 A.2d at 1156. Respondents—along with the court below and several others, including the California Supreme Court, *see 20th Century Ins. Co.* v. *Garamendi*, 8 Cal. 4th 216, 878 P.2d 566, 32 Cal. Rptr. 2d 807 (1994), *cert. dismissed*, 115 S. Ct. 1085 (1995), *cert. denied*, 115 S. Ct. 1106 (1995) —disagree, arguing that the cost of capital "has never been the sole standard against which the adequacy of a regulated entity's return must be measured." Opp. at 10. This Court should grant the writ to resolve this basic conflict on the constitutional standard applicable to rate regulation takings claims.

2. Respondents attempt to avoid the question presented by arguing that "the law prescribes no single methodology or formula for determining the constitutional adequacy of rates of a regulated entity." Opp. at 9. But this case is not about methodology; it is about the end result.

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[4] *E.g.*, *Central Maine Power Co.* v. *Public Utils. Comm'n*, 153 Me. 228, 136 A.2d 726, 740 (1957) ("one of the constitutional rights of a regulated utility is the right to earn a sufficient return to maintain its credit and to obtain additional capital when needed to enable it to serve its public") (quoting *New England Tel. & Tel. Co.* v. *Department of Pub. Utils.*, 327 Mass. 81, 97 N.E.2d 509, 516 (1951)).

It is certainly true that the Constitution does not mandate any particular method for measuring rate of return or reasonable cost of capital. The cases cited by respondents hold that "[i]t is not the theory but the impact of the rate order which counts," *Hope*, 320 U.S. at 602; *Duquesne*, 488 U.S. at 314, and—as we made clear in our petition, *see* Pet. at 12—we agree. The state may set rates pursuant to whatever theory it chooses, but if the *impact* of the order lowers a regulated firm's return below the cost of capital, the state has taken that firm's property.

*Duquesne*, on which respondents attempt to rely, makes this point palpably clear. In refusing to second-guess the particular method of ratesetting employed by the state, this Court emphasized that

> No argument has been made that these * * * rates jeopardize the financial integrity of the companies, either by leaving them insufficient operating capital or by impeding their ability to raise future capital. Nor has it been demonstrated that these rates are inadequate to compensate current equity holders for the risk associated with their investments. [488 U.S. at 312 (footnote omitted).]

Those are, of course, precisely the claims made here.

3. The state also attempts to obfuscate the issue by arguing that nothing in the Constitution guarantees any individual firm a particular rate of return. Opp. at 12-13. Again—as we made clear in the petition, Pet. at 15—we agree. That is not what this case is about. If State Farm achieved returns below the cost of capital because of poor management or just plain bad business luck, it would have no claim. But even the court below acknowledged that that did not happen here. As the court put it, State Farm established that "it experienced no unusual casualties or other factors which reduced its rate of return;" even the state's experts "all conceded that they could find nothing in State Farm's experience in New Jersey, *other than the*

*surtaxes and assessments*, which would produce the low rate of return." Pet. App. 31a (emphasis added). As the court concluded, nothing in the record suggested "that State Farm's rate of return was caused by factors other than the surtaxes and assessments." *Id.*

This is not a facial challenge or a theoretical dispute that the state can deflect through such hypotheticals. The record confirms that State Farm failed to recover its reasonable cost of capital *because of* the direct impact of the surtaxes and assessments, which it was not permitted to recover in the rates it could charge. Under this Court's precedents, that constitutes a taking.

4. Perhaps the clearest evidence that something is very much awry here is that the state offers no defense of the lower court's decision to adopt a nationwide industry average return standard in place of the cost of capital. Instead of even trying to defend the constitutional analysis of the court below, the state attempts to resuscitate the "confidence interval" approach that court rejected. *See* Pet. App. 31a-32a. Under this theory, the state's position is that an allowed rate of return as low as *negative* 3.6% would be constitutional, even given the findings that State Farm "experienced no unusual casualties or other factors which reduced its rate of return." Pet. App. 31a. When the state does not defend the constitutional analysis in the decision under review, and instead argues that a firm which experienced nothing "other than the surtaxes and assessments, which would produce the low rate of return" (*id.*) nonetheless has no takings claim even when the state lowers its return to negative 3.6%, the need for action by this Court is clear.[5]

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[5] The state also tries to create factual disputes where none exist. There is no dispute on the record that the reasonable cost of capital was 13%. *See* Pet. App. 9a-11a, 91a ("the conclusion is warranted that the investors' long-term expected or required return is in the area of 13.0 percent"). The state argues that this cost of capital figure should not be the measure of a constitutional fair rate of return, Opp. at 11-14, but does not challenge the ALJ's

5. With respect to the second question presented, we explained in our petition that the state violated petitioner's due process rights by compelling it to pay taxes before a determination of its constitutional claim, without providing a "clear and certain remedy" through which petitioner could later recover the wrongfully exacted amounts. We explained that such a remedy was required by this Court's "*McKesson* line of cases." *Reich* v. *Collins*, 115 S. Ct. 547, 551 (1994).

In their opposition, respondents do not even cite—much less attempt to distinguish—this Court's decision in *McKesson* or, for that matter, *any* of this Court's cases on which we relied in the petition. All that the respondents do is quote selectively from the conclusory ruling of the court below, neglecting to point out that even that court acknowledged that "[w]e do not think the Commissioner has provided meaningful standards." Pet. App. 40a. Respondents emphasize that State Farm was allowed to submit whatever evidence it wanted, Opp. at 15, which is completely beside the point. Our objection—clearly stated in the petition, Pet. at 20—was that the pertinent standards against which the evidence was judged shifted throughout the proceeding. Not only do respondents have no answer to that objection, they revel in it, *see* Opp. at 11, and compound it by once again shifting standards, refusing to defend the nationwide industry average standard adopted by the court below and resuscitating the confidence interval theory that court rejected.

Nor do respondents even attempt to answer our claim that the postdeprivation procedure violated due process by imposing a markedly harsher constitutional standard than would apply in a predeprivation remedy. Under the system upheld below, a firm would be entitled to the 13%

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finding, Pet. App. 91a—adopted by the court below, *id.* at 11a—that the cost of capital was 13%. There is a very real legal dispute over what the constitutional standard should be. There is no dispute over what the cost of capital was, or that the cost of capital was not employed as the constitutional standard below.

cost of capital return if it presents its claim in a predeprivation procedure, but only a 4.8% return if it is relegated to a postdeprivation procedure. This even though the constitutional claim is the same. This plainly does not satisfy *McKesson*'s mandate that a postdeprivation procedure is only "fully adequate" if it affords the relief that " 'prompt injunctive relief would have achieved.' " 496 U.S. at 41, 43 (quotation omitted). The state offers no answer because it has none.

6. Respondents continue their ostrich-like tactics when it comes to the broader significance of this case. They claim the questions presented are unique, but once again do not even cite—much less attempt to distinguish—the very recent cases from other states we cited raising the same issues, or the recent statutory enactments that pose the same constitutional questions. *See* Pet. at 23-25; *see also* Brief *Amici Curiae* of the American Insurance Association and the National Association of Independent Insurers, at 9-12. Those cases confirm that the departure from the cost of capital standard is not an isolated quirk, but a problem that will persist and steadily grow until this Court reaffirms that, as Justice Brandeis put it, "[t]he compensation which the Constitution guarantees an opportunity to earn * * * includes not only operating expenses, but also capital charges," *Southwestern Bell Tel. Co.* v. *Public Serv. Comm'n*, 262 U.S. 276, 290-291 (1923) (concurring opinion), or, as Justice Souter put it more recently, that a firm's "threshold entitlement is to a rate of return equal to the cost of capital." *Public Service Co. of New Hampshire*, 547 A.2d at 271.[6]

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[6] Respondents make much of the fact that the 51-page, signed opinion below has not been designated for publication, *see* Opp. at 2, 6a, but this Court has repeatedly admonished that the fact that a decision under review is unpublished carries no weight in the decision to grant certiorari. *See Commissioner* v. *McCoy*, 484 U.S. 3, 7 (1987) ("We note in passing that the fact that the Court of Appeals' order under challenge here is unpublished carries no weight in our decision to review the case. The Court of Appeals

## CONCLUSION

For the foregoing reasons, and those in the petition, this Court should grant the writ and reverse the decision below.

Respectfully submitted,

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exceeded its jurisdiction regardless of nonpublication and regardless of any assumed lack of precedential effect of a ruling that is unpublished."); *Rose* v. *Clark*, 478 U.S. 570 (1986) (reversing unpublished opinion); *Spectrum Sports* v. *McQuillan*, 506 U.S. 447 (1993) (same). Any other approach may encourage courts not to publish decisions raising serious questions meriting this Court's review. *See United States* v. *Edge Broadcasting Co.*, 113 S. Ct. 2696, 2702 n.3 (1993). In any event, the significance of the decision below has been recognized by insurers and regulators throughout the industry. *See, e.g., Journal of Commerce* (Feb. 8, 1996) at 7a ("New Jersey Case Draws Broad Industry Interest").